Internal Revenue Service

memorandum

CC:TL
Br3:WEWilliams

date: 19 FEB 1986

to: Acting District Counsel, Indianapolis CC:IND

from: Acting Director, Tax Litigation Division CC:TL

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subject: Production Credit Associations - 4th District
Your ref: CC:IND:TL RJBartlett

This responds to your memorandum dated January 31, 1986, in which you request technical advice with respect to certain issues that are likely to arise in the audits of production credit associations.

Issues:

1) Whether the Service is correct in making adjustments for the failure of production credit associations to report accrued interest on slow-paying loans, which had not been written off as bad debts, in computing their taxable incomes?

2) Does a production credit association's peculiar status as a "quasi-governmental entity" or a "federal instrumentality" make it immune from determinations of significant deficiencies resulting from its failure to report interest income?

3) Does a production credit association's peculiar status as a "quasi-governmental entity" or a "federal instrumentality" make it an inappropriate target for the Service's assertion of fraud or negligence additions under I.R.C. § 6653?

4) Should consideration be given to assessing preparer penalties against the accounting firm of [redacted] because of its preparation of returns in which production credit associations failed to report the accrued interest on slow-paying loans?

Conclusions:

1) We concur in the Service's view that the PCAs improperly failed to accrue the interest income so long as the facts support the conclusion that the underlying loans remained collectible at the time the interest accrued. In no case should a PCA be permitted to reverse a prior interest accrual even if the underlying loan becomes uncollectible subsequent to the accrual.

2) We do not believe that a PCA's status as a federal instrumentality affords the association immunity from any federal income tax deficiencies.

3) It is the Service's policy not to assert any interest or penalties against instrumentalities of the United States.

4) Because the Director, General Litigation Division, has jurisdiction over the section 6694 penalty, we have referred your request for technical advice on this question to that Division for response.

General Facts:

The taxpayers that are the subject of your technical advice request, Production Credit Associations (PCAs), are associations organized and operated under the terms of the Farm Credit Act of 1933, as amended. Pursuant to 12 U.S.C. § 2091, ten or more farmers may draft proposed articles of association that are forwarded to the federal intermediate credit bank for the district in which the farmers reside. The proposed articles must be accompanied by the farmers' agreement to subscribe on the association's behalf to stock in the credit bank in such amount as the bank may require. The proposed articles must be approved by the credit bank as well as by the Governor of the Farm Credit Administration. Upon the Governor's approval, the association is issued a charter and becomes "a federally chartered body corporate and an instrumentality of the United States."

Each PCA is operated by a board of directors elected from its voting members (12 U.S.C. § 2092) and subject to the supervision of the federal intermediate credit bank for its district and by the Farm Credit Administration. The powers of a PCA are enumerated in 12 U.S.C. § 2093 and include the right to purchase the stock and to contribute to the capital of the intermediate credit bank; to borrow money from the credit bank or with the credit bank's approval from other banks or financial institutions; and to make and participate in loans.

Under 12 U.S.C. § 2094, a PCA may issue voting stock, nonvoting stock, preferred stock, and participation certificates to raise capital for the association. Generally, a PCA is formed to enable its members to borrow from the Farm Credit Administration through the intermediate credit bank for their district. A PCA is authorized to make short-term loans not exceeding 7-year terms to its members. Under 12 U.S.C. § 2095, each PCA is required to set aside in a reserve earnings equal to one-half of one percent of its outstanding loans until the reserve equals three and one-half percent of its outstanding loans. 12 U.S.C. § 2098 provides the following:

> Such associations, their property, their franchises, capital, reserves, surplus, and other funds, and their income shall be exempt from all taxation now or hereafter imposed by the United States or by any State, territorial, or local taxing authority;.... The exemption provided in the preceding sentence shall apply only for any year or part thereof in which stock in the production credit associations is held by the Governor of the Farm Credit Administration.

Discussion:

Issue 1 - Accrued interest adjustments made by PCAs

PCAs are on the accrual method of accounting and accrue interest income on outstanding loans to their members on a monthly basis. Each PCA is required to maintain a bad debt reserve pursuant to 12 U.S.C. § 2095. However, certain PCAs have adopted the practice of not accruing interest on slow paying, delinquent, but not uncollectible loans, and of reversing previous accruals of interest income on loans that appear to be on the verge of default but which have not been formally transferred to an uncollectible account or for which bad debt deductions have not been claimed. The issue is whether the PCAs have correctly failed to accrue this interest and reversed the accruals on other loans.

I.R.C. § 451 provides the general rule that the amount of any item of gross income is includible in the taxpayer's gross income in the taxable year in which received, unless under the taxpayer's method of accounting, the item is properly accounted for in a different period.

Section 1.451-1(a) of the Treasury Regulations provides that income is includible by an accrual basis taxpayer when all the events occur fixing the right to receive such income. All the events that fix the right to receive income occur the earlier of when (1) the required performance occurs, (2) the payment therefor is due, or (3) payment therefor is made. In the case of a loan, interest is consideration paid for the use of money, and performance occurs when the lender allows the borrower to use his money. When the lender has allowed the use of his money for one day, one day's performance has occurred and one day's interest accrues (assuming that payment has not already been made or come due). Thus, unless interest is paid or such payment is due earlier, interest accrues ratably over the term of the loan. See, e.g., Luhring Motor Co. v. Commissioner, 42 T.C. 732, 742 (1964); and Rev. Rul. 74-6077, 1974-2 C.B. 149.

However, a fixed right to a determinable amount does not require accrual if the income item is uncollectible when the right to receive arises. See, e.g., Jones Lumber Co. v. Commissioner, 404 F.2d 764 (6th Cir. 1968); Samuel S. Steele v. Commissioner, T.C. Memo. 1969-177; George L. Castner Co. v. Commissioner, 30 T.C. 1061 (1958); and Rev. Rul. 80-361, 1980-2 C.B. 164. The issue of the collectibility of the underlying income item is resolved at the time the right to receive the income (interest) is fixed. Jones Lumber Co., supra; and Rev. Rul. 80-361, supra. The principle that accrual of a fixed right to a determinable amount is inappropriate if the income item is uncollectible appears to have first developed in Corn Exchange Bank v. United States, 37 F.2d 34 (2d Cir. 1930), in which the court stated that a taxpayer even though keeping its books on an accrual basis, should not be required to pay tax on accrued income unless it is good and collectible, and, when it is of doubtful collectibility or it is reasonably certain it will not be collected, it would be an injustice to the taxpayer to insist upon accrual and taxation.

In Spring City Foundry Co. v. Commissioner, 292 U.S. 182 (1934), the Supreme Court states that

> [k]eeping accounts and making returns on the accrual basis, as distinguished from the cash basis, import that it is the right to receive and not the actual receipt that determines the inclusion of the amount in gross income. When the right to receive an amount becomes fixed, the right accrues....

> If ... accounts receivable become uncollectible, in whole or part, the question is one of the deduction which may be taken according to the applicable statute .... It is not altered by the fact that the claim of loss relates to an item of gross income which had accrued in the same year.

Although Spring City Foundry dealt with the sale of goods, represented by open account and unsecured notes, that later in the same year became of doubtful collectibility, we think that the principles developed by the Court in that case are applicable to the accrual of interest income.

In Atlantic Coast Line Railroad Co. v. Commissioner, 31 B.T.A. 730, 751 (1934), acq., XIV-2 C.B. 2, aff'd 81 F.2d 309 (4th Cir. 1936), cert. denied 298 U.S. 691 (1936), the Board of Tax Appeals had the opportunity to apply Spring City Foundry to accruals of interest income. The Board observed that

> [t]he meaning of the language used by the court in the quoted opinion [Spring City Foundry] must be sought in the light of the facts of that case. At the time that the taxpayer's "right to receive" arose, it is not shown that the debtor was insolvent or that the debt was not good and collectible. The fact that the obligation later became worthless in part, even though within the same taxable year is, therefore, immaterial; as stated by the court, the question then became one of the deduction which might be taken according to the applicable statute. But where the obligation is worthless at the time the "right to receive" arises, as in the instant case, the right to receive is without substance and there is in fact nothing to accrue. Accrual of a worthless item in such circumstances obviously would result in distortion of gross income, and in our opinion the court did not intend its reasoning to be so applied as to reach the same result on a materially different state of facts.

In Clifton Mfg. Co. v. Commissioner, 137 F.2d 290 (4th Cir. 1943), the court observed that in the case of an accrual basis taxpayer

> interest is ordinarily accruable when the right to receive it is fixed, and not when it is actually received; but ... it is not accruable as long as reasonable doubt exists as to the amount that is collectible by reason of the financial condition or insolvency of the debtor.

See also Life Insurance Co. of Ga. v. United States, 650 F.2d 250 (Ct. Cl. 1981).

Collectibility or noncollectibility of a debt is a factual issue. Treas. Reg. § 1.166-2(a). In Hubble v. Commissioner, T.C. Memo. 1981-625, the court stated that

> [w]orthlessness of a debt is determined by an objective standard which is met by a showing of identifiable events which form the basis of reasonable grounds for abandoning any hope of future recovery. [Citation omitted.] The subjective good faith opinion of petitioners alone is insufficient. [Citation omitted.] Whether a debt has become worthless is a question of fact, the answer to which lies in an examination of all the circumstances. [Citation omitted.] The burden of proof with respect to this issue is on petitioners. [Citations omitted.]

We have not been provided with facts relating to the collectibility of the specific loans for which the PCAs failed to accrue interest. However, your memorandum indicates that none of the loans had actually been declared uncollectible. We concur in your view that the PCAs improperly failed to accrue the interest income so long as the facts support the conclusion that the underlying loans remained collectible at the time the interest accrued. In no case should a PCA be permitted to reverse a prior interest accrual even if the underlying loan definitely becomes uncollectible subsequent to the accrual. Under these circumstances, a taxpayer's remedy is not a reversal of the accrual, even if the uncollectibility occurs in the same taxable year as the accrual, but rather is a bad debt deduction under section 166. See Rev. Rul. 80-361, supra.

Issues 2 and 3 - The effect of PCAs being "instrumentalities of the United States"

Section 2098 of 12 U.S.C. provides that PCAs and their obligations "are instrumentalities of the United States..." and, as we have previously pointed out, these

> associations, their property, their franchises, capital, reserves, surplus, and other funds, and their income shall be exempt from all taxation....

However, 12 U.S.C. § 2098 specifically states that this tax exemption is effective only so long as the Governor of the Farm Credit Administration holds stock in the PCA for some or all of the taxable year.

In 1961, Congress in P.L. 87-343 (1961), amended the Federal Farm Loan Act and Farm Credit Act of 1933, to provide statutory authority for additions to bad debt reserves by PCAs equal to one-half of one percent of outstanding loans up to three and one-half percent of outstanding loans. 12 U.S.C. § 2095(a). The legislative history of this provision indicates that it was intended to prevent the Service from contesting the reasonableness of additions to the bad debt reserves of PCAs when the additions do not exceed the additions permitted by 12 U.S.C. § 2095(a). H.R. Rep. No. 1112, 87th Cong., 1st Sess. 10 (1961). This committee report also contains the following:

> As provided by Congress ..., the production credit associations are instrumentalities of the United States and, while the United States holds any class A stock in such an association, it is exempt from taxation - Federal and State .... When a production credit association retires all of its class A stock held by the Government, the association becomes subject to Federal income tax. Since the Government holds class A stock in only 13 of the associations, this means that the other 475 associations out of a total of 488 are now subject to Federal income tax.

The legislative history of the Farm Credit Act of 1971, P.L. 92-307, in referring to the then 441 PCAs, states that

> [i]nitially, the associations were largely capitalized by the United States. Now, how-

> ever, all Government capital has been retired and they are completely owned by their members. [Emphasis added.]

S. Rep. No. 92-307, 92d Cong., 1st Sess. 10 (1971).

The issue in Forrest City Production Credit Assn. v. United States, 300 F. Supp. 609 (E.D. Ark. 1969), aff'd per curiam 426 F.2d 819 (8th Cir. 1970), was whether plaintiff, a PCA, was a taxpayer during the years up to and including December 31, 1960, at which time plaintiff lost its exemption from taxation under 12 U.S.C. § 2098. Resolution of this issue would determine whether plaintiff was permitted to change from a calendar year to a fiscal year accounting period without the Commissioner's approval pursuant to section 1.442-1(a) of the Treasury Regulations. The Government argued that although plaintiff was a section 501(a) exempt organization prior to January 1, 1961, this exemption related only to income taxes; that prior to this date, plaintiff was subject to employment taxes imposed by the Code and was, thus, a "taxpayer" within the meaning of section 7701(a)(14). Moreover, the Government argued that the fiscal year return filed by plaintiff was not its first return as required by the Regulation. In this regard, the Gvoernment pointed out that as a section 501(a) organization plaintiff filed annual information returns pursuant to section 6033.

The district court in Forrest City Production Credit Assn. substantially adopted the Government's position. That is, the court concluded that plaintiff was a taxpayer before and after it lost its income tax exemption (whether or not the prior exemption was based on the Farm Credit Act of 1933 or on section 501(a) and that the return filed by plaintiff on a fiscal year basis was not its first return. There is no indication in the court's opinion and no argument was made by the taxpayer that after the plaintiff lost its tax exemption it was to any extent exempt from the tax provisions of the Code. Therefore, we do not believe that there is any authority or any reason to take the position that a PCA is not subject to the tax provisions of the Code in the same manner as any other nonexempt taxpayer.

The issue is different with respect to penalties and interest. As we have pointed out, although all PCAs are apparently now capitalized with private funds and all Government capital has been repaid with the result that the PCAs are fully subject to federal taxation, Congress did not amend or repeal 12 U.S.C. § 2098 to eliminate the PCAs' designation as instrumentalities of the United States.

On November 6, 1984, the Service issued Policy Statement P-2-4 that states that "[p]enalties and interest will not be asserted against agencies or instrumentalities of the United States." Furthermore, section 5173.1 of the Internal Revenue Manual, dated November 15, 1985, contains the following:

> (1)Policy Statement P-2-4 was approved by the Commissioner on November 6, 1981. It provides for nonassertion of penalties and interest against agencies or instrumentalities of the United States. The change was made because the Comptroller General ruled (Opinion B-161457) that penalties and interest may not be paid from appropriated funds.
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> (3)The Director, Office of Management and Budget, has agreed to contact any agencies considered by the Service to be "consistently delinquent," for the purpose of determining the "cause of the problem."

While PCAs are now entirely capitalized with private, nongovernment funds, the Service's Policy Statement P-2-4 is clear that penalties and interest are not to be imposed on instrumentalities of the United States. Moreover, a PCA's payment of penalties or interest imposed by the Internal Revenue Code could be held to be paid indirectly from the federal funds appropriated to the PCA, through the intermediate credit bank, to make loans to farmers. Accordingly, neither penalties nor interest should be asserted against the PCAs by the Service.

Issue 4 - Return preparer penalties

Your memorandum states that you are considering asserting the section 6694 return preparer penalty against [redacted], the accounting firm that apparently prepared the U.S. Corporation Income Tax Returns, Forms 1120, for the PCAs in the [redacted]. Section (30)312.38 of the Internal Revenue Manual, dated October 26, 1984, delegates authority with respect to issuing legal advice on, among other Code sections, section

6694 to the Director, General Litigation Division. Accordingly, we are forwarding a copy of your technical advice request to the General Litigation Division with the request that that Division respond directly to you regarding issue 4.

MARLENE GROSS
Acting Director

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